UNITED STATES DEPARTMENT OF AGRICULTURE
FARM CREDIT ADMINISTRATION
WASHINGTON 25, D. C.

SUMMARY OF CASES
RELATING TO
FARMERS' COOPERATIVE ASSOCIATIONS

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Ordinary and Necessary Expenses

Among the deductions permitted to be taken under the Internal Revenue Code from gross income in order to arrive at net income, subject to tax, there are specified under Section 23(a)(1)(A) of the Internal Revenue Code "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *." The regulations (Regulations 111, Section 29.23(a)-1) state that business expenses deductible from gross income include "the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * *."

It must be remembered in dealing with all deductions under the income tax law that the concept of net income is a purely statutory one: No legal obstacle exists to the taxation of gross income; all deductions, in other words, are matters of legislative grace, not of right, so that when a taxpayer asserts that he is entitled to deduct any item he must show that the item comes within the language used by Congress. In order that expenses may be classified as ordinary and necessary expenses incurred in a trade or business, three elements must be presented, first, the taxpayer must be conducting a business, second, the expenses must be found to be ordinary and necessary, and third, they must be paid or incurred within the taxable year. It should also be noted that many other specific statutory deductions such as taxes, may also be business expenses. Clearly any given expense cannot be taken more than once. If it is taken under the heading of taxes while it also constitutes a business expense, it cannot again be taken as a business expense.

From reading the provisions of the code it will be observed that the expenses incurred in a business must be both ordinary and necessary in order to be deductible. The question naturally arises what are to be considered ordinary and necessary expenses within the meaning of the statute. The Supreme Court and other Federal courts frequently have passed upon this question. A well known tax authority has said with respect to this deduction:

> "The case law on the subject of deduction and business expenses indicates that most of the cases involve controversial questions of fact rather than of law, although it is frequently difficult to sever the two (Mertens Vol. 4, 24.01 page 304)."

In Commissioner v. Helsinger, 320 U.S. 467, the deductibility of a lawyer's fee was in question. The expense was incurred in a unsuccessful attempt to defend the taxpayer from action by the Postmaster General in issuing a fraud order with respect to a dentist's mail order business. The Board of Tax Appeals had declined to allow the deduction. The Circuit Court of Appeals reversed, and the Supreme Court affirmed, the Circuit Court of Appeals saying, (p. 475):

> "Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances. Except where a question of law is unmistakably

involved a decision of the Board of Tax Appeals on these issues, having taken into account the presumption supporting the Commissioner's ruling, should not be reversed by the federal appellate courts. Careful adherence to this principle will result in a more orderly and uniform system of tax deductions in a field necessarily beset by innumerable complexities. Cf. Hormel v. Helvering, supra. However, as we have pointed out above, the Board of Tax Appeals here denied the claimed deduction not by an independent exercise of judgment but upon a mistaken conviction that denial was required as a matter of law. We therefore affirm the judgment of the Circuit Court of Appeals reversing and remanding the cause to the Board of Tax Appeals."

The recent case decided by the Tax Court of the United States, Robert S. Seese, Petitioner v. Commissioner, 7 T. C. ____, passed upon the question of the deductibility of attorneys' fees. The fees were incurred in connection with services rendered to obtain the petitioner's release from the Navy. It was contended that his services were essential to the business in which he had been engaged and that, accordingly, the fees of the attorneys should be regarded as a business expense. In deciding that the deduction was not allowable, the court, by Judge Hill, made the following statement:

"We think the expense involved was essentially personal in nature and therefore cannot be considered ordinary and necessary business expense. Drawing the line between personal and business expenses is often difficult. Some expenses seemingly involve both personal and business elements but we think expenses such as the one involved here which results from a personal situation of the individual concerned as distinguished from any ordinary and customary characteristic of the business is essentially personal rather than business expense. The expense here involved was incurred in order to adjust petitioner's personal situation so as to enable him to engage in the Company's business. The present situation seems to us analogous in principle to those wherein a man incurs expenses to secure freedom from a mental institution in order to manage his own property or a woman pays nurse maids to care for her children to enable her to work outside the home. Eugene E. Hinkle, 47 B.T.A. 670; Henry C. Smith, 40 B.T.A. 1038, affirmed per curiam 113 Fed. (2d) 114; Mildred A. O'Connor, 6 T.C. 323. In all these situations, including the present one, the expense is directed to freeing an individual from a situation, personal in nature, in order to enable such individual to engage in business. Such expenses are enabling expenses based on personal consideration rather than those of carrying on a business. They are in principle similar to those incurred by a commuter or a student for specialized education. They are preliminary to the carrying on of business and derive essentially from the particular individual's personal requirements. We think the reasoning of the cases cited above control the present situation. Since we consider the expense essentially personal in character although incurred and paid by the company it follows that such expense cannot be considered an ordinary and necessary business expense. We hold therefore that respondent correctly disallowed the deduction."

The case of Kornhauser v. U. S. 276 U.S. 145, also involved the question of the deductibility of attorneys' fees which were incurred in the defense of a suit for accounting instituted by a former co-partner. The suit grew out of the conduct of a partnership business and it was alleged by a former partner that the petitioner had collected fees for services during the existence of the partnership, no portion of which the co-partner had received. The Commissioner of Internal Revenue had refused to allow the deduction of the attorneys's fee and the refusal resulted in the suit against the Commissioner. The court said that the expenditure for attorneys' fees was either a personal expense or a business expense, as it was not a living or family expense. It held that the expense was an "ordinary and necessary" expense, as a suit ordinarily and as a general thing necessarily requires the employment of counsel. The court referred to an opinion by the Solicitor of Internal Revenue and to another departmental ruling as well as a decision of the Board of Tax Appeals. In the Solicitor's opinion it was held that legal expenses incurred by a doctor in defending a suit for malpractice were deductible. In the other departmental ruling it was held that legal expenses incurred in defending an action for damages by a tenant who was injured while working the taxpayer's farm were deductible as a business expense. In the case determined by the Tax Board it was held that a legal expenditure made in defending a suit for an accounting and damages resulting from an alleged patent infringement was deductible as a business expense. After referring to these cases, the court, in determing that the deduction was allowable said:

> "The basis of these holdings seems to be that where a suit or action against a taxpayer is directly connected with, or, as otherwise stated (Appeal of Backer, 1 B.T.A. 214, 216), proximately resulted from, his business, the expense incurred is a business expense within the meaning of § 214(a), subd. (1), of the act. These rulings seem to us to be sound and the principle upon which they rest covers the present case. If the expense had been incurred in an action to recover a fee from a client who refused to pay it, the character of the expenditure as a business expense would not be doubted. In the application of the act we are unable to perceive any real distinction between an expenditure for attorney's fees made to secure payment of the earnings of the business and a like expenditure to retain such earnings after their receipt. One is as directly connected with the business as the other."

See also Lampkin v. Bowers, 50 Fed. Supp. 874.

Again, in Welch v. Helvering, 290 U. S. 111, the court discussed the meaning of the phrase "ordinary and necessary expense." The issue was whether payments made by a taxpayer are allowable deductions if made to the creditors of a bankrupt corporation of which the taxpayer was formerly an officer in an endeavor to strengthen the taxpayer's standing and credit. In discussing the word "ordinary" the court said, by Mr. Justice Cordozo:

> "Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may

happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. Kornhauser v. United States, 276 U.S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

In referring to what was done in the particular case under consideration - the payment of another's debt - the court said:

"Indeed, if language is to be read in its natural and common meaning * * *, we should have to say that payment in such circumstances, instead of being ordinary is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."

In the case under consideration, the court decided that the expenditure was not a deductible one because it was rather in the nature of a capital expenditure - one made for the purpose of maintaining good will which the court regarded as a capital asset. In this case, a footnote lists a number of decisions with respect to the allowability of deductions as ordinary expenses as follows:

Commissioner v. People's Pittsburgh Trust Co., 60 F. (2d) 187, allowing expenses incurred in the defense of a criminal charge growing out of the taxpayer's business; American Rolling Mill Co. v. Commissioner, 41 F. (2d) 314, allowing contributions to a civic improvement fund by a corporation employing half of the wage earning population of the city on the ground that the contribution was made to add to the skill and productivity of the workmen; Corning Glass Works v. Lucas, 37 F. (2d) 187, allowing donations to a hospital by a corporation whose employees constituted two-thirds of the population of the city; Harris v. Lucas, 48 F. (2d), allowing payments of debts discharged in bankruptcy but subject to be revived by force of a new promise. Lucas v. Ox Fibre Brush Co., 281 U.S. 115, allowing additional compensation paid to officers of a corporation for services previously rendered. There are also listed certain decisions specifying expenditures that were not to be regarded as ordinary expenses as follows; Hubinger v. Commissioner, 36 F. (2d) 724, disallowing payments by a taxpayer for the repair of fire damage distinguishable from repairs necessitated by wear and tear; Lloyd v. Commissioner, 55 F. (2d) 842, disallowing counsel fees incurred by the president of a corporation in prosecuting a slander suit to protect his reputation and that of the business; 105 West 55th Street v. Commissioner, 42 F. (2d) 840, and Blackwell Oil & Gas Co. v. Commissioner, 60 F. (2d) 257, disallowing

payments to stockholders in settlement of disputes between them which there was no legal liability to make; White v. Commissioner, 61 F. (2d) 726, disallowing payments in settlement of a lawsuit against a member of a partnership, the theory being that the payments enabled the partner to devote his undivided efforts to the business and protect his credit.

The following additional criteria have been laid down as tests for determining deductibility; (1) Since the statute designates business expenses the expenditures sought to be deducted must not have been incurred in connection with personal transactions such as expenses incurred in earning taxable income not arising from a trade or business; (2) The expenses cannot result in the acquisition of a permanent asset. If such an asset is acquired, the cost must be regarded as a capital expenditure except in certain special cases.*

In some cases the question arises as to what constitutes a trade or business. While this is not a difficult or abstruse question, it is well to draw attention to it since there have been contentions made that expenditures were deductible when it was ultimately determined that the expenditures in question were not made in connection with a business. The rule for determining whether any enterprise is a business within the meaning of the Revenue Code is referred to in the case of White's Will v. Commissioner of Internal Revenue, 119 Fed. 2d 619, where it was held that the trustees managing a trust estate are not engaged in business within the meaning of the act, the court said:

> "We are confronted, therefore, with the question whether the trustees, in the management of this trust estate, are engaged in a business within the meaning of the Revenue Act. The language of the statute itself gives no definition which we may automatically apply to a set of facts and find from such application an authoritative answer. Nor has the Supreme Court of the United States given us a formula by which varying sets of facts may be resolved. In deputy v. du Pont, 1940, 308 U. S. 488, 499, 60 S. Ct. 363, 369, 84 L. Ed. 416, Mr. Justice Frankfurter in a concurring opinion joined by Mr. Justice Reed stated that '"* * * Carrying on any trade or business," within the contemplation of § 23 (a), involves holding one's self out to others as engaged in the selling of goods or services.' As will appear from the facts stated below the activities of these trustees fall far short of meeting such a test." (Emphasis added)

Many questions arise with regard to the nature of specific expenditures and their classification either as current expenses that may be written off in the taxable year, or as capital expenditures that may not be deducted. Generally speaking, any expenditures which result in benefits realized and exhausted within the year are deductible provided they meet the other tests. If, on the other hand, they result in the acquisition of assets which have an economic life beyond the taxable year, they would ordinarily not be.

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*See Winding Gulf Colliery Co. v. Brast, 13 Fed. Supp. 743; Marsh Fork Coal Co. v. Lucas, 42 F. (2d) 83; United States v. Roden Coal Co., 39 Fed. (2d) 425; Commissioner v. Brier Hill Collieries, 50 F. (2d) 777.

deductible. In the latter case, the outlay may be recovered through other channels such as depreciation, depletion, and amortization allowances.

In the case of Edwards & Son v. Clarke, 29 Fed. Supp. 671, it was held that a departmental store maintaining two buildings and which constructed a tunnel under a street from one building to another must capitalize the expenditure rather than take it as a business expense.

A case similar to that of the department store is Parkersburg Iron & Steel Company v. Burnet, 48 Fed. 2d 163. The cost of alterations in the building necessitated by the installation of new machinery were held to be capital expenditures rather than business expenditures deductible for the tax year.

In Connally Realty Co. v. Commissioner, 81 Fed. 2d, 221, a building alteration was disallowed as a deduction. Here the court said:

> "This outlay of money is not an expense of business likely to happen any year, but was occasioned by an unusual occurance, one that does not often happen at all. Repairs to a building are necessary, and regarded as ordinary although occasioned in unusual degree by storm, flood, or the like. But this building fell into no disrepair, nor was it physically injured in any way requiring restoration. The city altered its street with detriment to the desirability of portions of the building for rent, but, so far as appears, without touching the building. The outlay was made in an effort to adapt the building to changed surroundings, but not to repair any physical damage to it. The withdrawal of a railroad frontage or the change of a neighborhood from residential to business or the like sometimes required remodeling or altering buildings to maintain their rentability. These are not ordinary expenses, although necessary, but are additional investments; not repairs, but improvements. If they do not make the property worth more, or to rent for more than before the change of conditions which required the alterations, they make it worth much more than it would be without the alterations. The added investment may forecast a loss, but the loss for income tax purposes is realized only when the building is disposed of. There is here a physical structure representing the investment. The benefit is not limited to the year of the expenditure, but is expected to continue for the life of the property. The expenditure, being considerable, cannot be regarded as an ordinary expense of a single year, but must be treated as an additional capital investment. Black Hardware Co. v. Commissioner (C.C.A.) 39 F. (2d) 460."

In the case of Helvering v. Windmill, 305 U.S. 79, the Supreme Court held that brokers' commissions were capital expenditures and must be added to the cost of securities purchased rather than deducted as business expenses.

In First National Bank & Trust Company of Tulsa v. Jones, 53 Fed. Supp. 842, it was held that premiums paid by a bank on life insurance policies held as collateral for a loan were properly deductible under the facts of

that case. Here the court held that the advances in question were made without hope of expectancy of repayment and therefore could not be said to be loans or debts; that they were justified by proper business precaution incident to the protection of collateral, and therefore that the expenditure was justified in the plaintiff's business under the circumstances.

So, we find, on reviewing some of the cases dealing with business expenses that while the subject is intrinsically simple, it may, nevertheless, be one with regard to which many questions may be raised. They are largely questions of fact but we have attempted here to state the principal guiding rules.

Trade Association - Right of Corporation To Be A Member

In Electrical Contractors' Association of the City of Chicago v. A. S. Schulman Electric Company, 391 Ill. 333, 161 A.L.R. 787, 63 N.E.2d 392, the question was presented of whether a corporation without specific statutory authority was authorized to be a member of an incorporated trade association; and the further question was also presented of whether it was legal for a trade association to collect dues based upon the volume of business done by each of its members.

The association brought this suit against the electric company to recover the difference between what the electric company had paid as dues and the amount that was owing "at the rate specified in the constitution and bylaws" of the association. The electric company alleged that the constitution and bylaws operated to restrain "trade and tended to stifle competition among the members of the trade generally." The electric company also pleaded that it never was a member of the association because an Illinois corporation could not legally become a member of the trade association, a non-profit corporation.

In holding against the electric company and in favor of the association the court said in part:

> "By the terms of the constitution and bylaws, participation in plaintiff's corporate affairs was limited to those who qualified to become members and who thereafter sustained their membership by payment of dues. The one who sought membership was required to make application in writing on blanks provided by plaintiff and accompany it with an initiation fee of $50. Each application had to bear the endorsement of two members in good standing. Upon receipt of the application, plaintiff referred it to its executive committee and if the committee approved, it was submitted to a vote at the next regular meeting of the members. A majority vote was a prerequisite to membership. Under such circumstances, the application, its approval and the constitution and bylaws constituted the agreement by which an applicant could become and continue to be a member of the association. They provided for the payment of dues by each member and in this action the constitution and bylaws constitute the basis of plaintiff's claims. If they contravene public policy, they are unenforceable and plaintiff's action fails. The contention of

defendant, that there was such violation, necessitates a construction and interpretation of the constitution and bylaws. This is a question of law. Zeigler v. Illinois Trust & Savings Bank, 245 Ill 180, 91 NE 1041, 28 LRA (NS) 1112, 19 Ann Cas 127.

"The substance of the provisions of the constitution and bylaws pertinent to the public-policy question is as follows: The preamble to the constitution stated that the interests of competitors are interdependent. 'Competitors who assist each other are mutually benefited and are themselves injured by acts tending to harm another. With co-operation "Competition is the Life of Trade," without co-operation competition is the death of trade.' The purposes of the association were enumerated to be, (1) the discussion of subjects of interest and value to the members; (2) the advancement and improvement of the industry; (3) the collection and dissemination of statistics and information of value to its members, and (4) co-operative action by the members in connection with all things bearing on the well-being of their industry. An executive committee of seven members was elected by ballot. The chairman of the committee was president of the association. The committee was given the power to select a secretary and treasurer, prescribe their duties and to appoint standing committies. As stated, they passed upon applications for membership but their decision approving an application was subject to the will of a majority of the members voting at a regular meeting. Originally, the constitution provided for three classifications of members but this was amended to include but two, namely, contractor-dealers and dealers. The former was defined as members 'who do not employ building construction mechanics that the Association makes working agreements with.' Dealer membership was defined as members who do not employ building construction mechanics and who are primarily engaged in the retail merchandising of electrical appliances. Dealer members were not allowed the privilege of debate or vote on matters concerning construction or labor working agreements. In addition to the initiation fee of $50, each member was to pay dues equal to 4/10 of 1 per cent of all construction or merchandising business, computed on monthly billings. A minimum of dues in any year was fixed at $75 for contractor-dealers and $50 for dealer members.

* * * * * * * * * * *

"Defendant contends that since the amount of dues each member pays to the association shall be equal to 4/10 of 1 per cent of the business transacted, this gives to every other member an interest in the contract and, having such an interest, creates a condition which tends to destroy competitive bidding. To adopt such a conclusion is to assume that dues paid will, in the course of time, be distributed to the members in the form of dividends. There is nothing in the constitution or bylaws to support it. It is a nonprofit corporation and the accumulation of money or the division of it in form of dividends to the members is not provided. The objects of the association, above enumerated, contain no reference to contractors' interest in the earnings of the association. The objects numbered 1, 2 and 3 clearly and definitely contain nothing that could be interpreted as a scheme among

the members to control bidding or to stifle competition. Purpose number 4 calls for co-operative action among the members in all things bearing on the well-being of the industry. Such purpose is broad, but to say that it contains a design to stifle competition is to go beyond its plain terms and ascribe ulterior motives to the members of the association where there is no basis for it.

"The sole question in this case is as to the validity of the agreement as evidenced by the constitution and bylaws of the association. It is not a case where we need go beyond the instrument to determine the interpretation the parties placed upon it; but evidence was introduced to show the consideration each member received for the dues paid. The one who was secretary and treasurer of the association for a number of years testified that the association employed an office secretary and a research engineer. In enumerating the things the association did for its members, he included the furnishing of statistical data, the obtaining of proper regulation of electrical inspection, assistance in furnishing expert advice in matters pertaining to the trade generally, and assisting in the designing of electrical appliances. It also appears from his testimony that the employees of the various members of the association were members of a labor union, and in connection with that, he stated: 'We formulate a standard form of agreement and labor trouble, and disputes are arbitrated and in case we can't settle our troubles, or if we have a disagreement or jurisdictional strife between two or more trades, we submit the matter to arbitrators and they settle it.'

* * * * * * * * * * *

"Trade associations, like co-operative organizations in the fields of labor and agriculture, are well established and accepted as American institutions. The Trade Association Survey, as prepared by the Department of Commerce in 1941, shows that out of a group of 204 national and regional associations selected at random approximately sixty-one percent levy dues on a sliding scale in proportion to the size or volume of business. In the 10th Annual Report of the Secretary of Commerce (1922) it was stated: 'The whole movement toward co-operative action arises from a fundamental need to which we must give heed. Where the objectives of co-operation are to eliminate waste in production and distribution, to increase education as to better methods of business, to expand research in processes of production, to take collective action in policing business ethics, to maintain standards of quality, to secure adequate representation of problems before the Government and other economic groups and to improve conditions of labor, to negotiate collectively with highly organized groups of labor, to prevent unemployment, to supply information equally to members and to the public, upon which better judgment may be formulated in the conduct of business; then these activities are working in the public interest.'

"<u>Our conclusion is that plaintiff's constitution and bylaws, and particularly the provision for dues, are not, under the facts shown, contrary to public policy.</u>

* * * * * * * * * * *

"Defendant's contention that it never became a member of the plaintiff association is urged on two grounds: (1) That the conditions stated in the bylaws by which a member was admitted to membership were never complied with by either of the parties, and (2) that defendant being a corporation could not legally become a member in a voluntary non-profit association. Defendant's letter of February 25, 1926, addressed to plaintiff, requesting the name of A. S. Schulman on the record be changed to read A. S. Schulman Electric Company was sufficient to be treated by plaintiff as an application for membership. Plaintiff had the right to waive the requirement of the rule that applications be on printed forms and endorsed by two members if it so desired. Parties could also waive the requirements as to voting upon the application. Notwithstanding the departure from the course prescribed by the bylaws, defendant's representatives attended 90 per cent of the meetings of the association. There was a provision which fixed a penalty of $2 for failure of a member to attend a regular meeting. Whether defendant's representative attended to avoid the penalty, or whether the attendance was prompted by an interest in the affairs of the association is immaterial, for in either event there is ample evidence that the parties considered defendant a member of the association. Under such circumstances, defendant is not privileged to open the question as to whether its agent acted without authority in sending the letter requesting a chance on the records to show it as a member. It cannot now claim that the payments of dues to plaintiff were made under a mistake of fact, that it thought it was a member when in fact it was not.

"The statute under which defendant was organized did not, during the period covered by the accounting, contain an express provision that a business corporation such as defendant could become a member of a nonprofit association such as plaintiff. Regardless of the statute, defendant become a de facto member if not a de jure member. From 1926 to 1939, it recognized its obligation to plaintiff and paid plaintiff $8607.82 as dues. It is conceded that the payment made was not all that was due. Defendant received plaintiff's services and accepted the benefits of being a member of the association. Under such circumstances defendant is in no position to say that the statute under which defendant was organized did not authorize the acceptance of it as a member." (Emphasis added.)

For other cases involving comparable situations see the note to the instant case in 161 A.L.R. 787.

<u>Director - Not Entitled to Preference</u>

In the case of <u>Farmers Cooperative Association</u> v. <u>Kotz</u>, ____ Minn. ____, 23 N.W.2d 576, the question was presented of whether a chattel mortgage given by the association to the defendant was invalid because he had been a director of the association for many years.

On September 6, 1944, the defendant, who had been a director and a treasurer of the association for many years, resigned. The association at that time

owed him a substantial amount of money on account of loans which he had made the association. On October 4, 1944, the board of directors voted that the association give a mortgage to the defendant on "all merchandise, equipment, book accounts, and notes receivable as security for money then owing him." And "On October 6, 1944, a mortgage of $3,500 was thereupon given defendant as security for the indebtedness then existing and for future advances, the aggregate of which should not exceed $4,500."

The defendant claimed that a provision in the chattel mortgage given to him was violated and on November 28, 1944, he instituted proceedings to foreclose the mortgage. On December 11, 1944, pursuant to notice the property covered by the mortgage was sold at public auction and bid in by defendant for $3,528.10.

Prior to this time the former manager of the association brought a suit against the association to recover commissions, and he obtained a judgment in his favor for $544.55. Execution on the judgment was returned unsatisfied, and thereupon in pursuance of a petition therefor a receiver for the association was appointed on December 20, 1944. The receiver then brought this action for the purpose of having the chattel mortgage given to the defendant and the mortgage foreclosure sale declared null and void.

In the trial court the receiver was successful, and the defendant then appealed to the Supreme Court of Minnesota. That court reversed the trial court and granted a new trial. In doing so, the court apparently proceeded on the theory that as the defendant was not a director of the association at the time the mortgage was given and as the evidence did not warrant the conclusion that prior to his resignation as a director he had arranged with the officers of the association or with its directors for the giving of a chattel mortgage to him, a new trial was justified. In reaching this conclusion the court, among other things, said:

> "When a corporation is insolvent, its directors cannot, by taking advantage of their fiduciary relation, secure to themselves a preference over other creditors. Taylor v. Mitchell, 80 Minn. 492, 83 N.W. 418. In 13 Am.Jr., Corporations, § 1271, the rule is thus stated: 'The great weight of authority is to the effect that a preferential transfer to a creditor who is an officer of the corporation in payment of, or as security for, a pre-existing debt is invalid if the corporation is insolvent. * * *. The denial of the right of directors of an insolvent corporation to obtain a preference by way of security or payment of debts due them by the corporation is not as a rule founded upon the trust fund doctrine, but upon the theory that it is inequitable that a director, whose position as to knowledge of conditions and power to act for the corporation gives him an advantage, should be permitted to protect his own claim to the detriment of others at a time when it is apparent that all the unsecured debts of the corporation are equally in peril and that all of them cannot be paid. The courts sustaining that rule regard the directors as in a sense trustee for all the stockholders and creditors, so far at least as to render it improper for him to act solely for himself in disregard of the interest of those for whom he is such trustee.'

* * * * * * * * * *

". . . At the time the mortgage was executed, defendant was a general creditor of the association, probably the largest creditor. But for the fact that he had been an officer and director of the association, there is no question that he could lawfully receive a preference.

"The general rule is stated in 14A C.J., Corporations, § 3081, as follows: '* * * The rule denying the right of officers of directors to secure preferences applies, although they are bona fide creditors, and to preferences to officers de facto as well as officers de jure. The rule cannot be evaded by resignation of a director shortly before execution of the security constituting a preference in his favor where it appeared that all arangements had been made to give him a preference at a time when he was still director and in consequence of a consultation with other officers and directors,' and cases in note 12. See also 19 C.J.S., Corporations, § 1391.

* * * * * * * * * *

"As has been stated, there is not testimony in the record to support a finding that defendant as director participated in authorizing the making of the chattel mortgage in question, and there is insufficient evidence to support an inference to that effect. Neither is there any evidence to support a claim of fraud. The securing of a preference by a general creditor from an insolvent corporation is not, in itself, fraudulent under the laws of this state."

Apparently the court was of the opinion that under the law of Minnesota, if the defendant had not made arrangements for the giving of the chattel mortgage to him prior to his resignation as a director and officers, the chattel mortgage would be valid and that the association would be entitled to prefer the defendant the same as any other general creditor might have been preferred by the association. In other words it was a question of fact as to whether at the time in question the defendant was entitled to be regarded as one who had a status comparable with that of a general creditor who had been at no time an officer or director of the association.

As indicated in the foregoing quotations, officers and directors of corporations may not ordinarily prefer themselves over other general creditors.

In the case of Clark v. Pargeter, et al., ——Kan.——, 52 P.2d 617 (Summary No. 1, page 8), the court held that an association may not under the facts of that case prefer stockholder creditors.

In another case (Darling & Company v. Petri, 138 Kan. 666, 27 P.2d 255) a cooperative handled fertilizer on a consignment basis and the consignor of the fertilizer was held entitled to sue a director for the purchase price of fertilizer when the director attempted to offset a debt which the association owed him against a debt which he owed the association for fertilizer.

OPA - Treble Damages

In the case of Porter v. Cokato Cooperative Creamery Association, 65 F. supp. 974, the OPA brought suit against the association to recover treble damages by reason of alleged over-ceiling sales of butter in violation of the Emergency Price Control Act of 1942, as amended, 50 U.S.C.A. Appendix, § 901 et seq., and revised Maximum Price Regulation No. 289.

A jury returned a verdict in favor of the cooperative, and OPA moved for a new trial, which was denied. The first headnote to the opinion of the court discloses the basis therefor:

> "In action by Price Administrator against creamery to recover treble damages for alleged over-ceiling sales of butter, evidence warranted verdict of jury that butter sold by defendant to another creamery in its retail department was a sale to an individual retail store within price regulation and that defendant was authorized under regulation to charge price received and that, if a violation of regulation occured it was not willful nor result of failure on part of defendant to take practicable precautions to prevent its occurrence, and motion for new trial would be denied. Emergency Price Control Act of 1942, as amended, 50 U.S.C.A. Appendix § 901 et seq."

Assets Sold By Trustees for Stockholders - Not for Corporation

In the case of Acamop Winery Distilleries, Inc. v. Commissioner of Internal Revenue, 7 T.C.______, it appeared that there was dissatisfaction among the stockholders of the corporation and that the dissatisfied stockholders were desirous of getting their money out of the corporation.

The attorney for the stockholders suggested that the corporation be dissolved and that the assets be distributed among the stockholders, who could then sell them, thus avoiding a tax on the corporation on account of profits that might have been derived by the corporation if it sold the assets.

In keeping with this idea, the stockholders entered into an arrangement under which the major part of the assets of the corporation were turned over to three trustees named by the stockholders, with authority in the trustees to sell the assets on behalf of the stockholders and to distribute the proceeds among the stockholders in proportion to their holdings.

The trustees, by the terms of the various instruments under which they acted, were authorized to act only for the stockholders, and they were not authorized to act in any way for the corporation. The corporation retained a small portion of its stock of wine and a few other assets to pay taxes, to meet certain obligations, and to pay the expenses incident to winding up its affairs. All of the remainder of its assets, including "wine, winery, real estate and other items, were distributed in liquidation to the trustees for the stockholders."

The Commissioner of Internal Revenue took the position that the sale of the assets by the trustees was, in legal effect made for the corporation,

and that therefore the corporation was liable to pay income taxes on account of any profits arising from the sale of the assets.

On appeal, the Tax Court held against the Commissioner, and held that the sale of the assets turned over to the trustees was made exclusively for the stockholder and not for the corporation, and hence that the corporation was not liable for income taxes on account of the sale of the assets. In so holding, the court said in part:

> "The Commissioner has taken an untenable position upon the main issue in this case. It is contrary to the stipulated facts and, as a consequence, is not supported by the cases upon which he relies. He contends that the trustees were 'trustees in dissolution,' acting for and on behalf of the corporation to carry out its liquidation and dissolution, they affected the sale for the corporation, the latter realized the proceeds and is subject to the tax on the net gain. He states in support of this contention that the authority given the trustees was for the purpose of liquidating the properties, settling the debts of the corporation, and paying the remainder to the shareholders. He cites Mrs. Grant Smith, 26 B.T.A. 1173, and First National Bank of Wichita Falls, Trustee, 3 T.C. 203, which would be helpful if the facts here were as the respondent states them, but the stipulation and the testimony are to the contrary.
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> "The assets of the corporation in the Smith case were transferred to an agent for the directors, who were acting as trustees in liquidation. The agent was not chosen by the stockholders and was not representing them in receiving or selling the assets. The trustee in the Wichita Falls case also acted for the corporation under circumstances unlike those here present.
>
> "The negotiations which led to the sale in the present case were begun after the liquidating distribution, were carried on by trustees elected by and representing only stockholders, were not participated in by the corporation in any way, and had no important connection with any prior negotiations. These facts distinguish this case from Mrs. Grant Smith, supra; Fairfield Steamship Corporation, 5 T.C. 566; affd., ____ Fed. (2d) ____ (6/21/46); Meurer Steel Barrel Co. v. Commissioner, 144 Fed. (2d) 383; certiorari denied, 324 U.S. 860; and Court Holding Co. v. Commissioner, 324 U.S. 331, cited and relied upon by the Commissioner, in which the negotiations leading to the sale were instituted and pushed to an advanced stage by representatives of the corporation. The case of Howell Turpentine Co., 6 T.C. 364, is similarly distinguishable.
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> "The trustees in the present case were not in form or in fact 'trustees in liquidation.' They were not named or authorized to carry out the liquidation of the corporation. The corporation was doing its own liquidating and dissolving. It retained assets needed in winding up its affairs and it was proceeding with its liquidation. If any further distribution in liquidation is permitted, it will make it. The trustees were not authorized to settle any debts of the corporation or to do anything else in its behalf. The assets distributed to the trustees were not in fact used to pay off any debts of the corporation. The

proceeds of the sale did not go to or benefit the corporation. The various instruments expressly provided that the trustees were to act solely for the stockholders in receiving the first liquidating distribution and in selling the assets thus received. The respondent may not distort the stipulated facts to support his determination.

"It is frankly conceded that the petitioner did not want to sell any of its assets because of the heavy taxes which would follow such a step. It refused to sell. It is also conceded that the stockholders wanted to get their money out of the petitioner and they formulated a plan for that purpose which was adopted in preference to any other because they thought it would be acceptable to possible buyers and tax advantages. The respondent says 'it would therefore be proper to disregard the trusteeship device in the computation of income tax liability under the rubric of Gregory v. Helvering, (1935) 293 U.S. 465; Alice H. Bazley, (1945) 4 T.C. 897, aff'd. (C.C.A. 3rd 1946) ___ F. (2d) ___; and Court Holding Company (1945) 324 U.S. 331.' Form sometimes gives away to substance in tax matters, but here the steps taken were real and genuine. Cf. Chisholm v. Commissioner, 79 Fed. (2d) 14. The cases cited are not authority for the proposition that the method resulting in most tax must be selected in preference to another, otherwise proper and permissible, which would result in less tax. The law is to the contrary. Gregory v. Helvering, supra.

* * * * * * * * * *

"The sale was made for the stockholders, who owned the assets sold. It was not made by or on behalf of the petitioner. No sound reason for taxing the corporation with any gain from the sale has been suggested. Conservative Gas Co., 30 B.T.A. 552; Central National Bank, Trustee, 25 B.T.A. 1123. Cf. Falcon Co., 41 B.T.A. 1128; affd., 127 Fed. (2d) 277; Chisholm v. Commissioner, supra; George T. Williams, 3 T.C. 1002; Fruit Belt Telephone Co., 22 B.T.A. 440; Robert Jemison, Jr., 3 B.T.A. 780." (Emphasis added.)

In cases involving situations analogous to that involved in the case under discussion some close questions of fact may be presented; and in some instances the corporation, in legal effect, has been held to have sold the assets in question. For instance, in the case of Commissioner of Internal Revenue v. Court Holding Company, 324 U.S. 331, which is cited above, the court held that the sale of the assets in that case was made for the corporation, and hence that the corporation was required to pay income taxes on any profits arising from the sale. Apparently, in that case before the assets had been distributed as a liquidating dividend to its two stockholders, the corporation itself had conducted negotiations and had carried the sale almost to a consummation before the liquidating dividend was declared.

Patronage Dividends - Unprofitable Sales Disregarded

In the case of Producers Crop Improvement Association v. Commissioner of Internal Revenue, decided by the Tax Court of the United States on August 16, 1946, 7 T.C. ____, the court passed upon the question of whether the association might pay patronage refunds only to members and decline to pay patronage refunds to nonmembers because the sales to nonmembers did not result in a saving or profit.

The association was engaged in the production and sale of hybrid seed corn. Apparently all of its sales to its members of hybrid seed corn were retail sales, and the members in the purchase of hybrid seed corn at retail paid an amount for the corn in excess of the costs and expenses properly attributable to such business.

All of the sales that were made by the association at wholesale were made to nonmembers, and the uncontradicted testimony was that none of these sales resulted in a "profit." The association was nonexempt, but the association desired to exclude or deduct from its gross income amounts which it had distributed to its members in the form of patronage refunds. Apparently the question was not raised of whether the association was under a mandatory obligation to pay patronage refunds. See American Box Shook Export Association v. Commissioner of Internal Revenue, 156 F.2d 629, Summary No. 31, page 7.

In holding that the wholesale sales, none of which were made at a profit, might be disregarded in the determination of and payment of patronage refunds, the court said;

> "The other disagreement on patronage deductions is as to the percentage of available earnings to be attributed to sales to 'members.' Apparently both parties understand who the 'members' are and it is not important that we do not. Both parties rely upon A.R.R. 6967 C.B. III-1, p.287, 289, which provides that 'In the absence of evidence to the contrary, it will be assumed that the dealings with members and nonmembers are equally profitable' and that the amount available for refund consists of earnings from member and nonmember business in proportion to the total amount of business transacted with each group. The Commissioner determined that 50.1 percent of the amount available for 1942 and 72.99 percent for 1943 was attributable to sales to members and, therefore, deductible. He included wholesale sales as nonmember sales in his computation of the percentages. The petitioner contends that wholesale sales should be disregarded, since they did not result in any profit. The uncontradicted unchallenged evidence is that wholesale sales never resulted in a profit. They may be disregarded in allocating the profits between member and nonmember sales." (Underscoring added)

As no patronage dividends were paid to nonmembers, if profits as a matter of fact had been made on the nonmember business the association would have been liable for income taxes thereon even though it had been distributed to members on a so-called patronage basis. It is not believed that there is any way by which earnings or profits made on

nonmember business may be distributed among the members of an association so as to relieve an association from liability for the payment of income taxes thereon. By establishing that no earnings or profits had been made by the association on the wholesale business which it had done with nonmembers, there was of course no basis for the payment of patronage refunds to the nonmembers. A patronage refund arises from an "over payment" in the case of a purchasing association. If no "over payments" are made, technically there could be no patronage refunds.

A patronage refund proceeds on the assumption that savings were effected on the business on which patronage refunds are paid. If such business is handled at cost there is, of course, no basis for patronage refunds and if business has been handled in the red this would mean that the member business had subsidized the nonmember business.

As the absence of profit on the nonmember business entitled the association to disregard this business in computing patronage refunds, so in the case of an exempt cooperative association "unauthorized" business from the standpoint of exemption from income taxes which it may do, that does not result in any profit, has been disregarded in determining the eligibility of an association for continued exemption. At least this appears to have been the holding in the case of Producers' Produce Company v. Crooks, 2 F.Supp. 969. In this case a marketing cooperative had bought products of a dealer and the Bureau of Internal Revenue on this account questioned the eligibility of the association for continued exemption, but as it appears to have been admitted that no profits were made by the association on this business the court held that the association continued to be eligible for exemption.

In the case under discussion it appeared that the association had not paid dividends on its stock for some years. In 1942 it paid a dividend equal to the dividend that the association was authorized to pay on the stock for each of the years in question. The association contended that the dividends (as provided in the resolution of its boards of directors) except for an amount that would cover the dividend for the year 1942, were paid out of reserves or surplus that had been accumulated in prior years and that the total amount of the dividends disbursed in 1942 should not be subtracted from the earnings or savings made by the association in that year. Section 115(b) of the Internal Revenue Code, however, provides in effect that it shall be presumed that dividends have been distributed from the most recently accumulated earnings. Therefore all dividends distributed in 1942 were regarded as paid from the earnings of savings made in that year. This operated to reduce the amount available for distribution among the members in 1942 in the form of patronage refunds, and of course operated to reduce the amount that the association could deduct or exclude in computing the amount of its net taxable income.

The association also urged that its 1941 income was abnormal and that a portion of the income of that year should be attributed to prior years, but the court found that the association had no "abnormal income" as defined in Sec. 721 (a) of the Internal Revenue Code.

If the association had prevailed in its contention that it has abnormal income in the year 1941, a portion of the income for that year would have

been attributed to prior years and the association would then have paid income taxes as of those years on the amounts of income attributed to them.

Social Security Taxes - Agricultural Labor - Nonmember Business

In the case of United States v. Colfax Grain Growers, Inc., 157 F. 2d ____, the court said:

> "The question presented by this appeal is whether a farmers' cooperative association is required to pay social security taxxs on its employees who perform services in connection with the warehousing, handling, grading and storage of agricultural commodities produced by both members and non-members of the cooperative when more than half the services rendered are performed on products of members of the cooperative association." (Emphases added.)

The position of the Bureau of Internal Revenue was that as the association had done a substantial amount of nonmember business it was not entitled to successfully urge that the labor in question was agricultural labor.

Under the regulations of the Bureau it was clear that if the association had done no nonmember business at all, that this grain marketing association with respect to the employees involved would not have been liable for any social security taxes. As will be shown later by quotations from the opinion, the court in effect held that the regulations of the Bureau of Internal Revenue were more restrictive than the court felt that the House and Senate reports on the bill that resulted in the amendment to the social security act that was involved in the case justified. In other words, the court was of the opinion that the Bureau should have given the language of the amendment a broader interpretation than it had done because of statements appearing in the House and Senate reports.

The Bureau of Internal Revenue, in the drafting of its regulations, proceeded upon the theory that the term "agricultural labor" was not to include the labor of those that were engaged in the handling of nonmember products, at least if the amount of nonmember products marketed was substantial in amount. In affirming the decision of the Federal District Court holding that the cooperative was not required to pay social security taxes on account of certain employees, the appelate court said in part:

> "The employees of taxpayer involved here received wheat and other grain of both members and non-members of taxpayer, at taxpayer's warehouses and elevators, weighed and graded it, put it in bins or stacked the wheat in sacks. The products of members and non-members were treated exactly alike and the undisputed evidence is that the non-member business of taxpayer varied between 27% and 38% of the total business done by taxpayer during the three years in question here.

"Under § 1600 of the Internal Revenue Code, employers are required to pay a tax on the wages paid to individuals in their employ 'during the calendar year with respect to employment * * *.'

"Under the definition of 'employment' in § 1607 of the code, agricultural labor of the type performed here is exempt from the tax 'only if such service is performed as an incident to ordinary farming operations * * *.' (Internal Revenue Code § 1607 (c) (1); (l) (4)). This definition of 'agricultural labor' was added by amendment in 1939, effective January 1, 1940. The applicable regulations dealing with this section state:

"'Generally services are performed "as an incident to ordinary farming operations" within the meaning of this paragraph if they are services of the character ordinarily performed by the employees of a farmer or of a farmers' cooperative organization or group as a prerequisite to the marketing, in its unmanufactured state, of any agricultural or horticultural commodity produced by such farmer or by the members of such farmers' organization or group. Services performed by employees of such farmer or farmers' organization or group in the handling, planting, drying, packing, packaging, processing, freezing, grading, storing, or delivering to storage or to market or to a carrier for transportation to market of commodities produced by persons other than such farmer or members of such farmers' organization or group are not performed "as an incident to ordinary farming operation."'

"The District Court found that between 27% and 38% of taxpayer's business was with non-members but decided that such business with non-members did not cause taxpayer to lose its exemption since the so-called 50% standard applied. In the instant case more than 50% of taxpayer's business concededly was done with its own members. The District Court gave judgment for the full amount payed, and denied the Government's counterclaim.

"The Government contends that the Regulations, by defining the statutory terms 'agricultural labor' and 'service performed as an incident to ordinary farming operations', as not including services performed by employees of farmers cooper tives on the products of non-members, 'specifically prevent recovery by taxpayer in this suit and argues that because the taxpayer's non-member business amounted to between 27% and 38% of the total business during the years in question, taxpayer's employees 'do not qualify for exemption as "agricultural labor," because they devoted a substantial portion of their services to the agricultural products produced by non-members of the cooperative.'

"It is the Government's theory that a cooperative doing any substantial non-member business does not come within the exemption from social security taxation granted by Congress.

"We do not agree. Farmers' cooperatives have long been granted special favored treatment by Congress in taxation and other fields,

and in all such statutes the cooperatives given this favored treatment are cooperatives where the non-member business does not exceed 50% of the total business done.

"'So far as the Congress is concerned, the 50 percent provision has been interwoven into our law through many and varied and repeated enactments.' Bowles v. Inland Empire Dairy Association, 53 F. Supp. 211, 217. Dist. Ct., E.D. Washington.

"Nothing appears in the Social Security Act which indicates that Congress intended to depart from its prior practice of favoring a cooperative who business with non-members is less than 50 percent.

"Indeed, so far as the Congressional intent may be gleaned from the House and Senate Committee reports on the 1939 amendment adding the definition of 'agricultural labor' (§ 1607 (1) of the Internal Revenue Code) it is clear that Congress meant the 50 percent standard to apply in determining whether labor performed for a farmers' cooperative was to be exempt agricultural labor or not.

"The House and Senate Reports, in identical language, after declaring that 'The expression "as an incident to ordinary farming operations" is, in general, intended to cover all services of the character described * * * which are ordinarily performed by the employees of a farmer or by employees of a farmers' cooperative organization or group as a prerequisite to the marketing, in its unmanufactured state, of any agricultural or horticultural commodity produced by such farmer or by the members of such organization or group.', go on to state, 'To the extent that such farmers, organizations, or groups, engage in the handling, etc., of commodities other than those of their own production or that of their members, such handling, etc., is not regarded as being carried on "as an incident to ordinary farming operations." In such a case the rules set forth in subsection (c) of this section apply.'

"The subsection (c) referred to is in the Old Age Insurance Law and is identical with subsection (d) of § 1607 of the Internal Revenue Code, relating to the Unemployment Compensation Law, herein involved. That latter subsection, applying as it does the 50% standard to determine whether services which, in part, constitute taxable 'employment' under the act are to be wholly taxed, when read with the House and Senate Committee reports above quoted, clearly indicates the congressional intent to grant tax exemption to the same type of cooperatives as favored in other statutes, namely, a cooperative where non-member business does not exceed 50% of the total business done.

"The applicable Regulations, relied on by the Government to support its contentions, closely follow the language of the committee reports except in one regard. The committee reports declare that where employees of cooperatives handle commodities produced by non-members the 'rules set forth in subsection (c)',

[which, as we have said, in effect applies the 50% standard to determine whether an activity constitutes taxable employment] shall apply. But the Regulations are silent on what rules shall apply in cases where employees of cooperatives handle commodities of non-members.

"Thus, the Regulations not only do not forbid the application of the customary 50% standard to determine whether cooperatives are entitled to the tax exemption, but the Regulations do not set any standard to determine that; consequently, they do not require the interpretation given them by the Government, namely, that any substantial non-member business will cause a cooperative to lose its tax exemption.

"And while it is true that administrative interpretations and regulations are to be accorded great weight by the courts in construing statutes because of the superior knowledge of administrative officers of administrative needs, we cannot construe a regulation so as to defeat the intent of Congress as we think it is expressed in committee reports hereinbefore quoted.

"Here the Regulation so closely conforms to the House and Senate Committee explanations of the statute that it is a fair assumption that the Committe reports were at least before those who drafted the Regulations but in drafting the Regulations the reference in said committee reports to subsection (c) seems to have been ignored. The Regulations, read with the committee reports, are consistent with the congressional intent expressed in those reports, and indicate clearly that the 50% standard, applied so frequently to cooperatives in the past, was intended to be applied here." (Emphasis added.)

In the case of <u>Cache Valley Turkey Growers Ass'n</u> v. <u>Industrial Com'n</u>, ___ Utah ___, 144 P2d 537 (Summary No. 22, p. 5, and citations therein given), the court referred to the House and Senate committee reports referred to above, in holding that the association was not required to pay social security taxes on certain employees.